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No. 73-517

Supreme Court, U. S.
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In the Supreme Court of the United States

OCTOBER TERM, 1973

EARL VEST AND FAY VEST, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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1. For an indeterminate price, petitioners transferred to the Shell Oil Company the right to extract an indeterminate amount of water from under their land. Reversing the Tax Court, the court of appeals held that the agreement transferring the water rights was a form of lease so that the payments received by petitioners were taxable as ordinary income.[1]

[1] The court of appeals also held that certain other payments received by petitioners for surface rights were taxable as ordinary income (Pet. App. B 25a-27a). Petitioners, however, have not sought review by this Court of that aspect of the decision.

Under the agreement, petitioners transferred to Shell the right to extract water between 3,000 and 6,500 feet under their land, together with a right-of-way over the surface to enable Shell to construct and maintain a pipeline. Neighboring landowners entered into similar agreements with Shell. Whether Shell would need the water, and how much, were speculative matters since it acquired the water rights only as a reserve for possible secondary recovery of oil by water flooding. Shell did not obtain the right to extract all of the water at the specified depths, for petitioners reserved a paramount right to use as much of the water as they found necessary for mineral exploration. The volume of production was entirely within the control of Shell and it was not obligated to extract any water at all. Even if Shell commenced taking water, it could at any time reconvey to petitioners, free of liability, the water rights at issue, if production fell below a certain level, an event which Shell was free to arrange (Pet. App. B 13a-15a).

The agreement did not require Shell to make any fixed payment for the water rights. Rather, Shell undertook only to make payments based on specified percentages of its receipts from sales of water (or based on a percentage of the value of the water it used) where the water was extracted from petitioners' land or from neighboring lands, or was transported through any pipeline which it might construct over the lands involved. The payments (if any) were to be spread over a period of 75 years. If Shell did

not extract or transport water as described, petitioners would receive nothing (Pet. App. B 14a-15a).

During the taxable years at issue, Shell did not drill any water wells or construct any pipeline on petitioners' land. It did, however, pay petitioners approximately $26,600 for water extracted and transported from neighboring properties (Pet. App. B 15a).

2. The court of appeals correctly applied well-settled principles in holding that the payments received by petitioners were taxable as ordinary income from a leasing arrangement and not as capital gains from a sale. This Court has stated that the term "sale" is to be given its usual and ordinary meaning for purposes of taxation. *Commissioner* v. *Brown*, 380 U.S. 563, 571; *Helvering* v. *Flaccus Leather Co.*, 313 U.S. 247, 249. One of the prerequisites of a sale is that there be specific property transferred for a fixed price payable over a short term. *Iowa* v. *McFarland*, 110 U.S. 471, 478; *Bryant* v. *Commissioner*, 399 F. 2d 800 (C.A. 5); *Moberg* v. *Commissioner*, 365 F. 2d 337 (C.A. 5); *Nassau Suffolk Lumber & Supply Corp.* v. *Commissioner*, 53 T.C. 280.

Here, however, petitioners received no fixed consideration for the water rights payable over a short term. To the contrary, the payments they received were based entirely on receipts from water extracted from their land or from neighboring properties over a 75-year period. If Shell chose not to develop the properties, petitioners would receive nothing. Since

petitioners' right to payments was dependent upon Shell's extraction activities, there was not a transfer of a specific property interest for a fixed price.

Similarly, another essential element of a sale—that the transferor part completely with his ownership of specific assets—is lacking here. Petitioners' retention of an unlimited contractual right to any water necessary for mineral exploration, in effect a reversionary interest, is incompatible with a sale. *Puckett* v. *Commissioner*, 23 T.C.M. 238, 240-241, affirmed *per curiam*, 355 F. 2d 551 (C.A. 5).

3. Contrary to petitioners' argument (Pet. 10-14), the decision below does not conflict with *Anderson* v. *Helvering*, 310 U.S. 404, or its progeny of cases invoking the economic interest doctrine. Under this line of authority, a taxpayer is not entitled to a depletion allowance unless he has an economic interest in a mineral deposit. Such an interest is evidenced by an investment in the mineral in place with respect to which the owner is solely dependent upon extraction for a return of his capital investment.

If a transferor of mineral rights retains his economic interest by continuing to look solely to production for a return of his investment, the economic interest cases indicate that no sale has occurred but that the transfer is in the nature of a lease, the payments upon which are eligible for percentage depletion. *E.g.*, *Palmer* v. *Bender*, 287 U.S. 551; *Rutledge* v. *United States*, 428 F. 2d 347 (C.A. 5); *Oliver* v. *United States*, 408 F. 2d 769 (C.A. 4); *Belknap* v. *United States*, 406 F. 2d 737 (C.A. 6);

United States v. *White*, 401 F. 2d 610 (C.A. 10); *Hair* v. *Commissioner*, 396 F. 2d 6 (C.A. 9); *Royalton Stone Corp.* v. *Commissioner*, 379 F. 2d 298 (C.A. 2), certiorari denied, 389 U.S. 978; *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977; *Rabiner* v. *Bacon*, 373 F. 2d 537 (C.A. 8); *Freund* v. *United States*, 367 F. 2d 776 (C.A. 7). Conversely, if the transferor does not look solely to production for the consideration payable on the transfer and the transfer is of a fixed amount of minerals for a fixed price, the arrangement will be considered a sale taxable as capital gain, the proceeds of which are not eligible for percentage depletion. *Anderson* v. *Helvering*, *supra*; *Gowans* v. *Commissioner*, 246 F. 2d 448 (C.A. 9).

Petitioners contend that because they were to be paid by Shell not only out of production from their own land but also out of production and transportation of water extracted from neighboring properties, they did not retain an economic interest and hence made a sale. By so arguing, petitioners assume that the economic interest doctrine applies to non-depletable minerals such as water,[2] notwithstanding that the economic interest cases, including *Anderson*, involve only depletable minerals. But even under petitioners' theory that the economic interest doctrine is determinative of this case, the court of appeals did not conclude, contrary to *Anderson*, that petitioners had an economic interest in the water rights

[2] Section 613(b)(7) of the Internal Revenue Code of 1954 excludes water from the percentage depletion allowance.

at issue. To the contrary, it simply observed (Pet. App. B 19a, n. 10) that the economic interest concept was "a valid and helpful analogy in the solution of the issue involved in this case."

While we agree with petitioners that they did not have an economic interest in the water underlying the neighboring property within the meaning of *Anderson*, that case itself points out that the application of the economic interest test is only one factor in determining whether a sale of mineral rights occurred. Unlike this case, *Anderson* involved a sale of specific assets which were irrevocably conveyed for a fixed price, payable in any event. Here, however, where both the amount of minerals and the consideration payable therefor were indeterminate and the transferor maintained a significant reversionary interest in the minerals, petitioners cannot persuasively contend that a sale of their water rights occurred solely because Shell undertook to make payments measured by the water extracted from the adjoining property. Such payments are analogous to delay rentals—"amount[s] paid for the privilege of deferring development of * * * [petitioners'] property" —which are taxable as ordinary income, and ineligible for the depletion allowance. See Treas. Reg., 26 C.F.R., § 1.612-3(c)(1) and (2).

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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